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ECONOMIC OUTLOOK

Chamber of Commerce of the United States

November/December 1988

WHITHER ECONOMIC GROWTH

With a new Congress, a new President and the old Fed, there promises to be a hard-fought debate over the budget deficit that will have ramifications for the entire economy. The battle lines are already drawn. President-elect Bush remains firm in his belief that the correct way to reduce the deficit is to reduce the growth rate of government spending, not to increase taxes. Several returning members of Congress already have suggested that the only deficit reduction Congress will pass involves a combination of tax increases and spending restraint.

Some members of the Federal Reserve Board (Fed) seem to be determined to keep economic growth at 2.5 percent or less. These members continue to assert despite evidence to the contrary–that economic growth is excessive causing a rise in inflationary pressures. Thus, the Fed continues to keep short-term interest rates high in order to put a damper on growing credit demand and to slow the economy.

The consensus among economic forecasters is that the six-year economic expansion will become a seven-year expansion and that while the Fed will have its way on economic growth, it will not reduce inflation significantly. We predict higher growth than the consensus and a lower inflation rate, because we believe that as members of the Fed become increasingly aware of waning inflationary pressures, they will let the economy grow more rapidly. Thus, real GNP in 1989 should rise 3.7 percent, almost matching the moderate pace of growth experienced throughout the last six years. Our prediction is just above the average postwar growth in real GNP of 3.3 percent.

We feel confident about our prediction but are mindful of the dispute over the economy's growth potential and the possible ramifications for economic policy that may result from the outcome of the debate. At the heart of the debate is the assessment of potential noninflationary growth. The Federal Reserve, following Okun's Law, has placed it between 2.5 and 2.8 percent. The simple way of arriving at a potential growth number in this range is to add the growth in the labor force, about 1.7 percent, to the growth in productivity, about 1.1 percent.

Unfortunately, estimates of productivity are seriously flawed, especially in the services sector. They fail to take into consideration increasing returns to capital that result from technological change, and they underestimate the productivity improvements inherent in an older, more experienced work force. Furthermore, government measures of productivity inadequately measure output in the services sector. If one focuses on manufacturing productivity, for which current measures are best suited, a different picture of growth potential emerges.

Manufacturing productivity has been growing by an average of 4.6 percent each year since the economic expansion began. During this expansion, both manufacturing output and employment have risen. Services sector output and employment have also risen. If services sector productivity is really far below that of manufacturing, wage data should show a large increase in manufacturing wages as compared to service sector wages. This has not happened. The relationship between wages in the manufacturing and services sectors has remained almost the same throughout the expansion, indicating that overall productivity improvement may be closer to the more accurately measured manufacturing productivity. If one accepts this premise, the estimate of growth potential is much higher than 2.5 percent. Thus, there is no reason to

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TABLE I
UNITED STATES ECONOMIC OUTLOOK 1988-1990
Prepared by the U.S. Chamber of Commerce
(Percent change from previous period at seasonally adjusted annual rates unless otherwise indicated.)

	QUARTERS								YEARS			
	Actual		Forecast						Actual	Forecast		
	88:2	88:3	88:4	89:1	89:2	89:3	89:4	90:1	90:2	1987	1988	1989	1990
GROSS NATIONAL PRODUCT													
Real GNP	3.0	2.2	2.0	5.0	4.0	3.8	3.3	2.5	2.6	3.4	3.8	3.7	3.0
Consumption	3.0	3.5	3.2	4.6	3.9	3.5	3.2	1.8	2.0	2.7	2.8	3.7	2.6
Residential Investment	1.3	1.3	3.4	7.2	9.8	10.8	7.4	-0.7	-4.5	0.1	-2.5	6.2	2.4
Nonresidential Investment	15.0	4.6	5.2	5.7	6.6	6.6	5.8	2.8	2.1	2.8	10.2	6.3	4.0
Equipment	19.2	5.8	6.6	7.0	7.8	7.6	6.4	2.7	1.9	5.2	14.3	7.7	4.2
Structures	3.3	1.6	0.8	2.0	2.8	3.6	4.1	3.0	2.8	-2.9	-0.3	2.3	3.2
Exports	9.1	8.4	9.9	6.9	7.1	7.7	7.6	8.1	8.2	13.1	17.4	7.9	7.9
Real Net Exports ($25B)	-92.6	-94.9	-93.0	-92.0	-89.6	-87.5	-89.7	-86.4	-83.1	-128.9	-94.0	-90.0	-80.0
Imports	-3.7	6.7	7.1	8.9	8.3	7.7	5.2	4.2	2.3	7.9	7.7	7.2	4.3
Government Purchases	3.9	-1.4	2.8	9.2	2.6	1.1	3.4	-4.5	0.3	1.7	-3.1	3.0	0.2
Final Sales	6.3	2.4	4.7	5.4	5.0	4.8	4.2	2.6	2.6	2.9	5.6	4.8	3.5
Change in Business Inventories ($25B)	35.3	33.8	19.0	36.2	46.0	41.5	36.9	45.1	42.0	34.4	38.5	38.7	38.5
Industrial Production	4.6	6.6	3.8	3.9	6.0	5.7	5.1	3.0	3.1	3.8	5.6	5.0	4.2
New Car Sales (mill.)	10.6	10.7	10.4	10.6	10.7	10.8	10.9	10.7	10.6	10.3	10.6	10.8	10.6
Domestic Car Sales (mill.)	7.5	7.6	7.3	7.5	7.7	7.7	7.7	7.6	7.5	7.1	7.5	7.7	7.5
New Housing Starts (mill.)	1.48	1.45	1.50	1.53	1.58	1.62	1.61	1.51	1.48	1.63	1.48	1.58	1.50
EMPLOYMENT, WAGES AND PRICES													
Civilian Unemployment Rate (%)	5.4	5.5	5.4	5.2	5.0	4.8	4.7	4.6	4.4	6.2	5.5	4.9	4.4
Compensation	4.2	5.4	4.9	5.1	4.6	4.7	4.8	5.7	4.6	3.8	4.6	4.8	4.8
Productivity	1.8	1.3	1.6	1.8	1.7	1.2	0.9	0.3	0.7	0.8	1.4	1.5	1.7
Unit Labor Costs	6.4	4.0	3.4	3.3	2.8	3.4	3.8	5.4	3.9	3.1	3.1	3.3	3.1
Consumer Price Index	4.8	4.7	4.1	3.9	4.1	4.0	3.5	4.2	2.6	3.7	4.0	3.8	3.5
Implicit GNP Deflator	5.5	4.4	4.4	3.9	2.8	2.8	2.8	4.2	3.2	3.3	3.3	3.7	3.2
Prime Interest Rate (%)	8.8	9.7	9.2	9.2	8.9	8.7	8.6	8.6	8.3	8.2	9.1	8.8	8.3
3-mos. Treasury Bill Rate (%)	6.2	7.0	7.1	7.0	6.9	6.8	6.8	6.8	6.6	5.8	6.5	6.9	6.6
Corporate Bond Rate (%)	9.8	10.0	9.4	9.0	8.7	8.4	8.3	8.4	8.4	9.4	9.7	8.6	8.3
Real Personal Disposable Income	0.5	4.7	4.8	5.3	2.2	2.0	2.0	0.7	1.9	1.2	3.7	3.6	2.0
Profits from Current Production ($B)[1]	21.5	-0.3	-6.4	52.2	9.2	-1.7	-4.0	7.5	-0.1	3.7	2.1	9.9	-1.3
GOVERNMENT FISCAL POLICY ($B)[2]													
Unified Receipts										854	909	988	1085
Unified Outlays										1005	1064	1134	1195
Unified Deficit										-151	-155	-146	-110

[1] Corporate profits with inventory valuation and capital consumption allowances.

[2] Unified budget figures on a fiscal year basis.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University macro model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains advance estimates of the National Income and Product Accounts for the third quarter of 1988. The nation's money supply M(1) is assumed to grow by 5.6 percent in 1988, 5.4 percent in 1989 and 5.1 percent in 1990. The trade weighted exchange value of the dollar falls by 1.4 percent in 1989 and 2.0 percent in 1990.

expect inflation to accelerate if the economy continues to grow at the post war average (3.3 percent) or even at the same rate experienced over the six years of this expansion (3.8 percent).

The concern over too high a rate of economic growth is bolstered by the view that declining unemployment will ignite inflation. However, there is no observable long-run trade-off between unemployment and inflation. Unemployment has been gradually reduced through tax rate cuts that increased the incentives to work and invest. Furthermore, employment shocks that might conceivably push wages up temporarily have been avoided. Inflation has been brought down because the rate of increase in monetary aggregates has slowed and the economy has grown. Today's inflation is a result of mistaken policies of the past taken by the Fed two years ago to lower the value of the dollar. These misplaced policies added far too much money to the economy.

There is nothing to fear from a growing economy and reduced unemployment. A low-unemployment economy is vibrant, enabling workers to obtain well-paying jobs, to spend little time searching for work, to avoid discouragement by finding rewarding work and to gain new skills. A growing economy opens up new job opportunities, challenges businesses to be competitive in product and factor markets, adds to profits and incomes and produces greater incentives for recycling the plant and machinery of a firm or industry that is in decline. In a growing economy, credit will be put to productive use eventually adding to the accumulation of products offered for sale and thereby holding down prices.

Since October 1987, analysts have alternated between fears of recession and accelerating inflation. Neither fear has come to pass, but a continuation of this same disaster-lurking mentality is driving many of today's forecasts and, unfortunately, the monetary policy of the Fed. The common thread to the disaster-mongers stories has been their low estimate of growth potential.

The choice of economic policies to reduce the deficit and to manage the money supply will affect the economic outcome in 1989. The policies adopted will also alter the potential for economic growth. President-elect Bush, the new Congress and the Fed must recognize, however, that sound economic policy goes beyond merely balancing budgets and fighting inflation. Sound economic policy should strive to improve the chances for economic growth by strengthening free markets.

In the almost 43 years since the end of World War II, the nations of the world have experimented with a great variety of economic systems, from totalitarian communism to free market democratic capitalism. Many countries over the years have moved back and forth between a more statist and a more libertarian system. From the wealth of data available about the relative performance of various economic systems, we can draw a number of conclusions about which economic policies foster economic growth and which do not. Since we know what works and what doesn't, we have some objective standards by which to evaluate the policies being considered for 1989. What works? The empirical evidence overwhelmingly supports the following:

- Those countries that provide strong and consistent protection for private property rights tend to grow more rapidly than those that do not. Policies that add to minimum wages and mandated benefits will reduce economic growth potential.
- An independent legal system that provides clear and fair outcomes fosters higher rates of economic growth. The return to a "fault based standard" in liability law will improve economic growth potential.
- Those countries that minimize interference with free markets (that is, where forces of supply and demand determine prices) will experience higher growth rates. Policies aimed at price deregulation will improve economic growth potential.
- Those countries that have had a high degree of price stability, resulting from a responsible and predictable monetary system, have tended to grow more rapidly than those that experienced high rates of inflation or deflation. The Fed should focus on gradual reduction of inflation by developing and publicizing their long-run strategy.
- Those countries that have had an open trading system (i.e., free trade) as opposed to a closed system (i.e., protectionist) have tended to have higher economic growth rates. Thus, protectionist policies such as "voluntary restraints" and trade retaliation must be avoided.
- As government spending increases as a share of GNP, economic growth rates tend to slow, so those countries with smaller shares of government spending as a percent of GNP have tended to grow more rapidly. Thus, the new Congress should work to reduce the rate of growth of federal spending by adopting a fair and flexible budget freeze.
- Those countries with relatively low marginal tax rates have tended to grow more rapidly than those countries with high marginal tax rates. Thus, tax rates should not be raised and the capital gains tax rate should be cut.

Let experience speak and be the guide. The six-year expansion has already spoken eloquently, as has the experience of many other countries. We know what works and what doesn't. Let us be persistent in rejecting political expediency over good economics.

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (millions) [a]	Sep '88	246.7	246.6	243.9	[c]	0.8
Gross National Product ($B)	III '88	4,899.5	4,823.8	4,568.0	1.6	7.3
Gross National Product (82$B)	III '88	4,007.3	3,985.2	3,865.3	0.6	3.7
Money Supply (M1) ($B)	Sep '88	782.5	782.5	747.5	[c]	4.7
Money Supply (M2) ($B)	Sep '88	3,035.1	3,031.8	2,880.8	0.1	5.4
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	III '88	3,527.6	3,194.6	3,058.2	10.4	15.3
Personal Consumption Expenditures (82$B)	III '88	2,601.2	2,579.0	2,545.2	0.9	2.2
Disposable Personal Income ($B)	Sep '88	3,513.2	3,496.9	3,240.3	0.5	8.4
Disposable Personal Income (82$B)	Sep '88	2,793.8	2,794.7	2,683.3	0.0	4.1
Personal Savings Rate (%)	Sep '88	4.2	3.8	2.5	0.4 [b]	1.7 [b]
Civilian Employment (millions)	Oct '88	115.5	115.3	113.2	0.2	2.0
Civilian Unemployment Rate (%)	Oct '88	5.3	5.4	6.0	-0.1 [b]	-0.7 [b]
Average Hourly Earnings	Oct '88	$9.45	$9.40	$9.08	[c]	4.1
Consumer Price Index (All urban 82=100) [a]	Sep '88	119.8	119.0	113.8	0.5	5.3
Prime Interest Rate (%) Oct. 27, 1988	Oct '88	10.0	10.0	9.3	0.0	0.7
Retail Sales ($B)	Sep '88	133.7	134.2	128.1	-0.4	4.4
SERVICES SECTOR						
Employment in Services (millions)	Sep '88	81.0	80.7	78.0	0.4	3.8
Consumer Purchases of Service ($B)	III '88	1,746.4	1,708.2	1,610.2	2.2	8.5
Consumer Purchases of Service (82$B)	III '88	1,288.5	1,274.8	1,246.8	1.1	3.3
Domestic Revenue Passenger Mileage Flown Major Airlines (billions) [a]	Sep '88	24.5	31.3	23.5	-21.7	4.3
BUSINESS PROFITS AND OUTPUT						
Corporate Profits and Cash Flow ($B)						
Before Tax	II '88	310.7	286.2	273.7	8.6	13.5
Profits Tax Liability	II '88	144.1	136.9	132.6	5.3	8.7
Tax Liability as a Percent of Profits	II '88	44.8	47.8	48.4	-3.0	-3.6
After Tax	II '88	166.6	149.4	141.1	11.5	18.1
Net Cash Flow	II '88	397.7	387.8	373.9	2.6	6.4
Industrial Production (77=100)	Sep '88	138.3	138.3	131.0	[c]	5.6
Capacity Utilization Rate (Mfg.) (%)	Sep '88	83.6	83.8	81.1	-0.2	2.5
New Housing Starts (thou. units)	Sep '88	1,453.0	1,431.0	1,679.0	1.5	-13.5
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77=100)	III '88	180.4	178.6	173.3	1.0	4.1
Unit Nonlabor Costs (nonfarm) (77=100)	III '88	172.7	171.8	173.0	0.5	-0.2
Producer Price Indices (82=100) [d]						
Crude Materials	Oct '88	95.8	96.6	95.3	-0.8	0.5
Intermediate Goods	Oct '88	108.6	108.7	103.1	-0.1	5.3
Finished Goods	Oct '88	109.3	108.6	106.2	0.6	2.9
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67=100)	Sep '88	669.5	675.2	639.2	-0.8	4.7
Fed. Gov't Gross Debt Outstanding ($B) [a]	Sep '88	2,602.2	2,575.8	2,355.2	1.0	10.5
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	III '88	526.3	507.1	440.4	3.8	19.5
Imports of Goods & Services ($B)	III '88	611.2	597.5	565.6	2.3	8.1
Deficit in Balance of Goods & Services ($B)	III '88	84.9	90.4	125.2	-6.1	-32.2
WHAT'S AHEAD?						
Index of Leading Indicators (67=100) [a]	Sep '88	193.3	193.4	191.9	0.1	0.7

NOTE: All data seasonally adjusted unless otherwise noted

[a] Not seasonally adjusted [c] Less than 0.05 percent

[b] Percentage point difference [d] Index number not seasonally adjusted, percent change seasonally adjusted

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ECONOMIC OUTLOOK

Chamber of Commerce of the United States

January/February 1989

"THEY SHALL NOT CRUCIFY MANKIND UPON A CROSS OF YEN"

Remember the last time you had to shovel three inches of "partly cloudy" off the driveway? Such weather forecasting errors are not uncommon, and although they make life inconvenient and draw the eternal ire of the public, they seldom have significant consequences. More importantly, the course of future weather patterns is not changed one whit by forecasting errors.

While economic forecasts have even less scientific basis than those of meteorologists, the consequences of economic forecasting errors may have significant and lasting effects on the future course of the economy. Economic policy and business planning have come to rely heavily on the conventional wisdom of economists' forecasts. Errors in forecasting the future of the economy are far from benign. Therefore, it is important to examine the accuracy of economic forecasts on a continuing basis.

Post-recession Forecasts

In October of 1988, the nation's economic forecasters began showcasing their outlook for the economy in 1989 and beyond. As a group, forecasters demonstrate a continuation of their growing pessimism that began in 1985, which runs directly contrary to the actual path taken by the economy since that time. The October Blue Chip consensus forecast (the average forecast for the 51 private forecasters polled) was 2.5 percent for real economic growth in 1989, down from their projection for 1988 of 2.8 percent.

Since the economic expansion began in 1983, the Blue Chip consensus forecast misestimated overall economic growth by an average of 0.70 percentage points, underestimating actual growth four times and overestimating it twice (it is generally expected that 1988 will have a 3.8 percent rate of growth when the final quarter data become available).

Similarly, the U.S. Chamber of Commerce (USCOC) forecasts underestimated actual GNP growth four times and overestimated it twice. However, our forecasts have consistently been more optimistic than the Blue Chip consensus and less inaccurate. USCOC forecasts in October for the following year have been above the Blue Chip consensus in every year since 1983, and our average deviation from actual experience was 0.68 percentage points.

Of the 41 private forecasters who have been contributing their forecasts to Blue Chip since 1983, the USCOC is one of only five forecasters who was more accurate than the Blue Chip consensus in forecasting actual economic growth. The average October forecast for the following year of the five best performers was always above the Blue Chip consensus deviating from actual GNP growth by 0.52 percentage points.

Blue Chip consensus forecasters include numerous very pessimistic analysts who have projected economic growth far below actual growth for many years. Since 1985, these pessimistic participants have brought the consensus forecast down even though actual economic growth has been on the rise. Moreover, the more optimistic participants in the Blue Chip panel tended to have more accurate forecasts of economic growth. The average of the highest ten forecasters in each year were closer to the actual economic growth rate in three of the years from 1983 to 1988 than the Blue Chip consensus. The average of the lowest ten forecasts have never been closer to the actual than the consensus.

In October 1988, the average of the top ten forecasters predicted 3.4 percent growth for 1989. The average of the best five performers from 1983 to 1988 predicted a 3.0 percent growth rate. If the experience of the last six years is a useful guide, policymakers and business planners should pay as much or more attention to the optimistic forecasters than to the Blue Chip consensus.

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GROSS NATIONAL PRODUCT												
Real GNP	2.5	2.1	5.2	3.1	3.8	3.6	3.1	3.1	3.4	3.9	3.5	3.3
Consumption	3.9	2.4	3.9	2.6	3.0	3.4	2.8	3.1	2.7	2.8	3.2	3.0
Residential Investment	4.3	4.7	0.4	0.7	6.0	5.0	0.0	1.5	0.1	-2.1	2.7	2.6
Nonresidential Investment	4.0	6.8	5.5	4.9	5.3	4.4	0.8	3.3	2.8	10.2	5.9	3.1
Equipment	4.6	8.0	5.6	5.9	5.6	6.1	1.3	3.3	5.2	14.2	6.8	3.9
Structures	2.6	3.5	5.1	1.9	4.5	-0.6	-0.6	3.3	-2.9	-0.1	3.3	0.7
Exports	14.5	6.8	8.3	8.6	6.2	6.6	8.7	8.2	13.1	18.0	8.5	7.5
Real Net Exports (82$B)	-93.9	-89.7	-86.3	-83.1	-79.1	-77.5	-72.5	-68.9	-128.9	-96.3	-81.5	-68.1
Imports	13.1	2.9	4.7	5.2	2.7	4.7	4.3	5.0	7.9	8.0	4.7	4.4
Government Purchases	13.2	6.3	7.7	2.9	3.1	4.5	-3.5	0.1	1.7	-3.8	2.7	0.7
Final Sales	5.3	4.2	4.4	3.8	4.2	4.0	3.5	3.9	2.9	5.7	4.2	3.8
Change in Business Inventories (82$B)	39.5	22.7	29.8	29.8	29.9	28.5	36.3	36.4	34.4	40.9	29.5	36.7
Industrial Production	6.6	5.4	3.9	4.2	5.3	3.9	6.1	2.5	3.8	5.7	4.8	4.2
New Car Sales (mill.)	10.7	9.8	10.3	9.9	10.2	10.3	10.3	10.5	10.3	10.5	10.2	10.5
Domestic Car Sales (mill.)	7.6	6.9	7.3	7.0	7.2	7.3	7.3	7.4	7.1	7.4	7.2	7.4
New Housing Starts (mill.)	1.45	1.41	1.45	1.48	1.50	1.51	1.49	1.48	1.63	1.46	1.49	1.48
EMPLOYMENT, WAGES AND PRICES												
Civilian Unemployment Rate (%)	5.5	5.3	5.4	5.3	5.2	5.0	4.9	4.8	6.2	5.5	5.2	4.8
Compensation	5.6	5.5	5.1	4.7	4.9	5.1	5.8	4.7	3.8	4.7	5.1	5.1
Productivity	1.9	0.5	1.2	1.6	1.9	1.7	1.4	1.7	0.8	1.5	1.1	1.6
Unit Labor Costs	3.7	4.8	3.8	3.1	2.9	3.3	4.4	2.9	3.1	3.1	4.0	3.4
Consumer Price Index	4.7	4.0	3.8	3.6	3.5	3.5	3.0	3.2	3.7	4.1	3.9	3.3
Implicit GNP Deflator	4.7	4.5	3.7	3.4	2.6	2.3	3.3	2.6	3.3	3.4	3.8	2.8
Prime Interest Rate (%)	9.7	10.3	10.2	9.9	9.8	9.5	9.2	9.2	8.2	9.3	9.9	9.1
3-mos. Treasury Bill Rate (%)	7.0	7.8	8.0	7.8	7.5	7.4	7.4	7.5	5.8	6.7	7.7	7.4
Corporate Bond Rate (%)	10.0	9.6	9.6	9.5	9.4	9.2	8.8	8.8	9.4	9.7	9.4	8.7
Real Personal Disposable Income	5.5	3.8	5.6	1.9	2.7	3.0	4.6	2.7	1.2	3.8	3.7	3.2
Profits from Current Production ($B)1	4.3	-12.0	15.2	19.7	10.4	-0.2	-14.8	6.7	3.7	4.1	7.4	-0.2

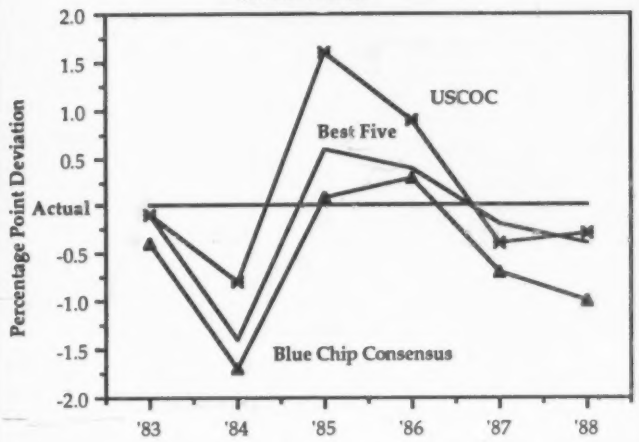
[1] Corporate profits with inventory valuation and capital consumption allowances.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University macro model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains final estimates of the National Income and Product Accounts for the third quarter of 1988. The nation's money supply M(1) is assumed to grow by 4.4 percent in 1988, 4.2 percent in 1989 and 4.1 percent in 1990. The trade weighted exchange value of the dollar rises by 2.0 percent in 1989 and 1.5 percent in 1990.

Forecast Deviations About Actual Real Growth Rates (1983-1988)



This Year's Outlook

Since October 1988, the Blue Chip consensus forecast for 1989 has increased by .1 growth point to 2.6 percent. The USCOC forecast has gone the other way, from 3.7 percent in October to 3.5 percent now. These two forecasts are getting closer, but the improved opportunities for economic growth reflected in the upward Blue Chip revision is moderated by the increased risks of policy mistakes that motivate the downward USCOC revision.

From the standpoint of the Blue Chip forecasters, they now appear more convinced that there is underlying strength in the real economy. We agree that the underlying strength of the economy is substantial, but our view is tempered by our belief that the Federal Reserve Board (Fed) appears determined to stifle the economy with inordinately high short-term interest rates for much too long a time and already has destroyed some of the economic growth that could have occurred in 1989.

We fear that the Fed, if it persists in slowing the economy further, runs the risk of causing a major economic slowdown over the next year and a half. We hope that members of the Fed will take note of recent signs in the economy—stable not accelerating inflation, rising not falling growth potential—and allow the economy to grow more rapidly.

The economy is currently growing at 3.8 percent over 1987. While the fourth quarter of 1988 will exhibit lower growth than that for all of 1988, the fourth quarter shortfall will be almost entirely due to the remaining impact of the 1988 drought on GNP statistics. There will be a solid reported real GNP growth spurt in the first quarter of 1989 when GNP measures include new, higher estimates of farm output for 1989.

Yet the soon-to-be reported gyrations in real GNP are mainly due to estimation quirks. The real, underlying economy shows uninterrupted strength. Factory orders continue to increase as does production. Employment and capacity growth with rising productivity all herald continued GNP growth. Domestic and foreign demand remain high enough to boost sales thereby encouraging sellers to add to their inventories in anticipation of even greater sales. While growth in 1989 will not be quite as strong as in 1988, the economy's vital signs are still very good unless the Fed's high interest rate policy causes the real economy to falter.

The Outlook for Inflation

Today's rate of inflation of about 4.5 percent is too high and should be brought down slowly. For the past two years, money supply growth, the single most important determinant of inflation, has been brought under control. Over the past year, the monetary aggregates M1, M2 and M3 have grown by about 4, 5 and 6 percent, respectively, well within Fed target ranges. However, in the last three months of 1988 the monetary aggregates have grown by only about 1, 2 and 4 percent, respectively, far below prudent rates of monetary growth. This slowdown comes as a result of concerted efforts by the Fed to reduce credit availability in order to slow economic growth.

It is important that the Fed gradually reduce monetary growth. However, it should avoid a sudden reduction in liquidity since it takes a long time for monetary restraint to show up in reduced rates of inflation, but only a short time to affect the real economy. Contrary to those who embrace the overheating scenario, inflation rates have nothing to do with economic growth rates. If the Fed is intent upon reducing inflation—a laudable goal—it will shoot itself in the foot if it continues to reduce monetary growth so severely, as such a severe reduction in monetary growth will create declining investment and production before it can impact inflation rates. As a consequence of an economic slowdown, enormous pressures will be felt at the Fed to reverse its inflation-fighting strategy to promote an economic turnaround.

Inflation should recede somewhat in 1989 as a result of the monetary control that was reestablished in 1987, but the abrupt reduction of money supply growth in late 1988 raises the odds of disrupting continued growth in the real economy.

Fed Policy

Criticisms of Fed policymaking are a dime a dozen, and Fed policymakers typically ignore outside advice.

But we believe a number of members of the Fed's Open Market Committee are seriously in error about how they view the economy and are convincing the Fed to fight the wrong battles with its limited policy tools. Fed manipulation of interest rates to fine-tune economic growth disrupts credit markets and retards growth in the real economy. Already the Fed has produced an inverted yield curve (some short-term rates exceed long-term rates) which, if this situation persists, is a harbinger of major economic slowdown.

The Fed has underestimated growth potential and, using a variety of dubious indicators, is arguing that the economy is overheating. Monthly price index data, however, continue to reveal stable inflation. Instead of assuring the public that inflation will come down with gradual monetary restraint, the Fed threatens Congress with high interest rates until the budget deficit is resolved to the Fed's satisfaction. It is evidently not enough that the budget deficit is falling absolutely and as a proportion of GNP.

And instead of focusing efforts on domestic monetary control, the Fed expends its energy in a futile struggle with international currency markets. By forcing dollar supplies up and down in a vain effort to hold the dollar within a narrow trading range, the Fed is hanging stable domestic monetary policy upon a "cross of yen."

Manipulation of liquidity and interest rates adds considerable risk and uncertainty to credit markets. Short-term interest rates remain unduly high in anticipation of further Fed credit restriction. Thus, there is a "Fed premium" built into short-term interest rates that keeps real interest rates much higher than necessary. The Fed should shift gears and concentrate on gradually reducing money supply growth—a goal that will take all of its time and effort—and should do so in an open manner so that markets understand its policy decisions. If it follows such a policy course, we believe the Fed premium would disappear and interest rates would fall even though the Fed's monetary policy would be described as being tight.

The Value of the Dollar

Continued economic expansion bodes well for increasing exports in 1989. The trade deficit and the current account deficit will continue to fall in real terms and as a proportion of GNP. A declining rate of inflation in the U.S. will help exports and reduce pressures for the dollar to fall.

The outlook for the dollar is tied to the prospects for continued economic growth. If President Bush sticks to a no-new-tax position, which he gives every indication of doing, the chances for continued economic growth will remain strong. As a consequence, U.S. assets will continue to be a good buy for foreign investors. And even though U.S. interest rates should fall throughout 1989, dollar-denominated securities will maintain their attractiveness due to a decline in the rate of inflation.

On balance, the dollar should rise throughout 1989 as the demand for dollars rises internationally. Recent declines in the value of the dollar came on the heels of election rhetoric over tax increases which served only to increase foreign concerns over economic growth in the U.S. Now that the election battle is over, the budget deficit debate has properly shifted to restraints in government spending and dollar demand has bounced back.

NOTICE A CHANGE IN THIS ISSUE?

Our bimonthly update of key economic data provided by "Trends in Commerce" has been replaced by the "Economic Snapshot" card which serves as a handy up-to-date guide to the latest reported data on key economic indicators. Please let us know if you wish to receive "Economic Snapshot" along with your issue of the *Outlook* by writing to Forecasting Section, U.S. Chamber of Commerce, 1615 H Street, N.W., Washington, D.C., 20062.

RECENT ECONOMIC POLICY DIVISION PAPERS

Lawrence A. Hunter and Orawin Velz, "Fiscal Snake in the Can."

Lawrence A. Hunter, "Putting a Lid on Runaway Federal Spending."

William K. MacReynolds, "Facts and Fallacies about Foreign Investment," *Policy Working Papers.*

Richard W. Rahn, "Do We Need a Tax Increase?," *Policy Working Papers.*

Orawin Velz, "Competitiveness is Alive, Well and Thriving in America," *Policy Working Papers.*

Testimony on Monetary Policy, by Richard W. Rahn, given before the House Committee on Banking, Finance and Urban Affairs.

Testimony on the Federal Budget Deficit, by Richard W. Rahn, given before the National Economic Commission.

Lawrence A. Hunter, "The Fair Freeze Solution to Balancing the Budget."

Teresa Kenneally, "The Savings Dilemma."

William K. MacReynolds, "Productivity Growth and Overall Economic Growth Potential."

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ECONOMIC OUTLOOK

Chamber of Commerce of the United States

March/April 1989

"WHO'S AFRAID OF FULL EMPLOYMENT?"

The report of the National Economic Commission closes the last avenue of escape for those members of Congress who would seek to avoid their responsibility to eliminate the deficit without raising taxes. Noting the estimated $82 billion in additional revenues that will flow into the Treasury next year, the Commission stated without equivocation, "It is clear that we do not have to and should not raise taxes, but, rather, should restrain the rate of growth in federal spending."

The report is a tribute to the wisdom and courage of the majority on the panel who, after months of being harangued by a parade of tax advocates, rejected the political expedience of Washington's conventional wisdom that new taxes are unavoidable. The Commission's majority, by sticking to sound economics, clearly demonstrated that they have the right stuff.

The Commission also made 12 specific recommendations to reform the federal government's budget process. Among the proposals put forward were the adoption of a biennial budget; enactment of a balanced budget constitutional amendment with limits on the ability of Congress to increase taxes; giving the President line-item veto authority; and numerous procedural changes to the budget process that would increase fiscal discipline by the federal government.

Reducing the federal deficit by limiting growth in federal spending buoys the outlook for the economy in 1990. By avoiding new taxes, the incentives that have created the longest peacetime expansion in our history will remain in force. However, deficit reduction policy is being held hostage by the Federal Reserve Board's high interest rate policy which is designed to reduce economic growth. Unfortunately for Congress and the new Administration, slower growth resulting from this policy will lead to higher government expenditures and less revenue, thus exacerbating the budget deficit problem.

There are already emerging signs of slowdown in the economy. Economic growth has fallen from the 5 percent annual rate reached at the end of 1987 to a 2.2 percent annual rate over the last half of 1988. Output in the nonfarm sector has steadily fallen throughout 1988 and currently is below 3 percent. Business investment actually declined from the third to the fourth quarter of 1988 and retail sales declined precipitously in February. The fall in automobile and other interest sensitive durable goods purchases so far in 1989 is a direct result of the Fed's high interest rate policy.

The Fed is engaged in "slash and burn" economic policy as is evidenced by a rise in short-term interest rates of over 300 basis points in less than a year. If the Fed maintains such pressure for too much longer, high interest rates will lead to severe curtailment in incentives to invest and produce. As in the past, ill-founded and exaggerated Fed policy to fine-tune the economy threatens to create economic instability.

There is still a little time, however, for members of the Fed to adopt more appropriate monetary policy. The rate of inflation should show clear signs of declining throughout 1989 due to the Fed's actions beginning in early 1987 to reduce the rate of growth in the money supply.

Yet, it remains to be seen whether the Fed will perceive a lessening in inflationary pressures and recognize actual declines in economic growth soon enough to induce it to abandon its high interest rate policy. Even if the Fed takes quick action to take the pressure off rising interest rates, the severity and length of Fed high interest rate policy to date leads us

Economic Outlook, published bimonthly by the Forecasting Section, Chamber of Commerce of the United States of America, provides its readership with the Chamber's official forecast of the U.S. economy. It analyzes the vital issues affecting current economic activity and provides the latest economic trends. Subscription cost is $60.00 per year which includes all *Policy Working Papers* published by the Economic Policy Division. Individual copies of the *Outlook* can be purchased for $7.50 per copy.

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UNITED STATES ECONOMIC OUTLOOK 1989-1990
Prepared by the U.S. Chamber of Commerce
(Percent change from previous period at seasonally adjusted annual rates unless otherwise indicated by shading.)

	QUARTERS								YEARS		
	Actual	Forecast							Actual	Forecast	
	88:4	89:1	89:2	89:3	89:4	90:1	90:2	90:3	90:4	1988	1989	1990
GROSS NATIONAL PRODUCT												
Real GNP	2.0	5.2	2.4	2.8	3.5	3.4	3.3	3.2	4.0	3.8	3.2	3.3
Consumption	3.5	2.6	1.6	2.5	2.9	2.9	3.3	3.1	3.9	2.8	2.8	3.0
Residential Investment	10.9	4.7	2.3	8.7	9.2	8.7	8.8	7.0	6.5	-1.7	5.8	7.2
Nonresidential Investment	-4.6	7.2	5.8	5.7	6.7	4.0	6.1	4.7	7.8	9.4	4.5	5.5
Equipment	-5.9	8.2	7.1	6.6	8.5	4.6	6.9	5.2	8.7	13.2	5.2	6.5
Structures	-0.3	4.2	2.3	3.1	1.5	2.2	3.4	2.9	5.2	-0.3	2.4	2.7
Exports	7.7	8.8	9.1	7.7	6.7	6.6	6.7	6.2	7.0	18.1	9.1	6.9
Real Net Exports (82$B)	-103.3	-95.3	-92.9	-89.4	-87.6	-86.5	-85.9	-85.8	-85.0	-99.7	-91.3	-85.3
Imports	13.0	2.1	6.1	4.3	4.6	5.0	5.5	5.3	5.9	8.6	6.2	5.1
Government Purchases	16.8	4.2	1.1	-0.1	1.6	-1.7	1.0	1.0	2.4	-3.2	2.8	0.4
Final Sales	3.1	3.8	2.7	3.5	3.8	3.9	4.5	3.8	4.9	3.7	3.9	3.9
Change in Business Inventories (82$B)	35.6	38.4	38.4	33.0	31.3	34.6	30.3	29.0	24.8	48.6	35.3	29.7
Industrial Production	4.0	4.2	4.7	4.9	6.5	5.5	5.7	5.8	7.6	4.7	5.0	5.5
New Car Sales (mill.)	10.5	9.8	9.7	10.3	10.5	10.7	10.8	10.6	10.8	10.6	10.1	10.7
Domestic Car Sales (mill.)	7.5	6.9	6.8	7.3	7.5	7.6	7.6	7.6	7.7	7.5	7.1	7.6
New Housing Starts (mill.)	1.55	1.50	1.52	1.59	1.60	1.64	1.66	1.67	1.75	1.49	1.55	1.68
EMPLOYMENT, WAGES AND PRICES												
Civilian Unemployment Rate (%)	5.3	5.3	5.2	5.0	4.8	4.7	4.6	4.5	4.4	5.5	5.0	4.7
Compensation	4.7	5.4	5.5	5.4	5.4	6.1	5.4	5.6	5.8	4.8	5.4	5.6
Productivity	-2.0	1.3	1.6	1.4	1.6	1.3	1.4	1.2	2.0	1.0	1.1	1.4
Unit Labor Costs	6.8	3.8	3.8	4.0	3.7	4.7	4.0	4.3	3.8	3.7	4.2	4.1
Consumer Price Index	4.1	4.1	3.5	2.9	3.3	3.4	3.3	3.3	3.7	4.1	4.0	3.3
Implicit GNP Deflator	5.3	2.4	3.0	2.7	2.8	3.5	2.9	3.1	3.2	3.4	3.6	3.1
Prime Interest Rate (%)	10.2	11.1	10.9	10.7	10.6	10.5	10.4	10.2	10.0	9.3	10.8	10.3
3-mos. Treasury Bill Rate (%)	7.7	8.3	8.1	7.8	7.6	7.5	7.4	7.3	7.2	6.7	7.9	7.4
Corporate Bond Rate (%)	9.5	9.8	9.5	9.3	9.2	9.2	9.3	9.2	9.1	9.7	9.4	9.2
Real Personal Disposable Income	4.7	3.9	-0.8	3.4	3.2	2.2	4.0	3.1	5.8	1.2	3.0	3.0
Profits from Current Production ($B)1	-8.7	45.9	0.4	-2.6	2.8	4.4	4.5	1.5	8.8	4.3	9.4	2.9

1 Corporate profits with inventory valuation and capital consumption allowances.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University macro model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains preliminary estimates of the National Income and Product Accounts for the fourth quarter of 1988. The nation's money supply M(1) is assumed to grow by 4.2 percent in 1989 and 4.1 percent in 1990. The trade weighted exchange value of the dollar rises by 2.0 percent in 1989 and 1.5 percent in 1990.

to reduce our forecast for real GNP growth in 1989 to 3.2 percent. If the Fed persists in its high interest rate policy, however, it will likely bring on a recession and cause a drop in our 1989 forecast again.

The Fed Communique

Our concern over Fed policymaking is based upon what we believe is unsound economic reasoning being used by some members of the Fed. We are not engaged in Fed bashing for its own sake, but we understand that the Fed lacks timely information on the course of the economy and is beset with policy instruments that are too crude to attempt to do anything but follow well-enumerated, long-term policies to fight inflation.

However, there are many aspects of official Fed reasoning about the economy upon which we can agree. We recently wrote to Fed Chairman, Alan Greenspan, to express our many areas of agreement with the Fed's point of view, and to register our concerns over excessive fine-tuning and an inappropriate high interest rate policy.

In our remarks to Chairman Greenspan, we noted that we agree with recent Congressional testimony by the Fed Chairman where he stated that: "Maximum sustainable economic growth over time is the Federal Reserve's ultimate objective. The primary role of monetary policy in the pursuit of this goal is to foster price stability."

Those statements are appropriate given the Fed is primarily responsible for both rising and falling inflation rates. To paraphrase another statement Mr. Greenspan made, we would also agree that today's rate of inflation is too high and since long-term inflation ultimately is due to excessive monetary growth, it must be brought down gradually by controlling the rate of monetary growth.

Gradual reduction in inflation is necessary because the reduction in monetary growth rates required to reduce inflation works with a fairly long lag in affecting the price level, but it affects the real economy with much shorter lags. If money supply is reduced too abruptly, as has happened over the last several months, it will unnecessarily reduce economic growth or produce a recession before it has any perceptible effect on inflation.

Our concern over Fed policy is not about its long-term goals, but about its failure clearly to enumerate its long-term policy approach. In addition, we find policies aimed at influencing economic growth to be inappropriate. Trends in the real economy, when divorced from changes in monetary growth, have little bearing on past, present and future inflation.

We pointed out to Chairman Greenspan that we are not chronic advocates of "looser money." We consider the persistent rate of inflation of over 4 percent as *prima facie* evidence that currently the supply of money exceeds its demand as the result of excessive money growth in the past.

Of course, we conceded that in the short run, the appearance of "cost-push" inflation is possible due to exogenous sources -- if taxes increase substantially, if the minimum wage is pushed up, if onerous new regulations are adopted, if supply shocks occur such as those that can be induced by OPEC. But the important point about such "cost-push" price increases is, even if it becomes a problem, the central bank can do nothing to alleviate it in the short run. The market must adjust on its own by either accepting a lower margin between prices and costs or by seeking to reduce costs by raising productivity. The worst thing the Fed can do is to accommodate price increases as it did during the oil crisis in the 1970s.

The Fed confronts two overlapping problems that it must sort out. Both problems are rooted in the central bank's earlier inflationary policies. In 1985, the Fed faced the task of gradually reducing the growth rate of money supply until it brought the inflation rate down from its then-current rate of about 3 1/2 percent. Unfortunately, the Fed did just the opposite. It caused inflationary pressures to increase by significantly accelerating money growth.

That surge in money supply is the major contributor to today's higher inflation. It will take some time for the excessive monetary growth of 1985 and 1986 to run its course. If inflation is a monetary phenomenon, it follows that an acceleration of inflation can threaten only if the central bank has created too much new money. Since over the past two years the Fed has been increasingly restrictive, there is no monetary basis upon which to predict an outbreak of new inflation. The Fed merely must be patient to allow the most recent burst of inflation to recede.

The second problem facing the Fed is how to return the economy gradually to the disinflationary path it abandoned in 1985. Adopting policies to accomplish this feat, not attempting to combat an acceleration of inflation it already baked into the system, is what the Fed should be absorbed with today. It is important that the Fed not let itself be diverted into an ill-fated, short-term excursion of attempting to combat the additional inflation it created two years ago, over which today it has little control.

A high interest rate policy to slow down the economy will not reduce long-run inflation. Certainly a recession will reduce short-term increases in prices, but at an enormous cost in jobs, income and the federal budget

deficit. But a significant slowing of economic growth adds impetus to a "loose money" response thereby introducing inflation back into the economy.

In order to achieve long-term price stability, Fed policy should follow quantity and price rules that are predictable and well understood by market participants. By announcing and following a basic quantity rule, the Fed will introduce stability and certainty into financial and business calculations that will allow markets to operate smoothly.

We urged the Fed to talk about a rule and specific targets rather than say the Fed is worried about inflation. When Chairman Greenspan says he is worried about inflation, the market thinks the Fed will push up short-term rates, hence short-term market rates rise on this expectation. The Fed then has to follow the market up, because if it doesn't, the market is disappointed. Long-term bond prices will fall because the market doesn't believe the Fed is fighting the inflation of which the Fed had previously warned, leading to more talk about accelerating inflation.

Thus, by talking about inflation problems, rather than specific targets, the Fed ends up creating a vicious cycle. The cycle can be broken and interest rates will fall if the Fed focuses its daily credit market activity and its public pronouncements on long-run money growth targets.

Occasionally, it will be necessary for the Fed to make short-term adjustments in the announced rates of monetary growth due to exogenous shocks to the economy or due to significant changes in the demand for money. A well-designed price rule will allow the Fed to determine when such adjustments are required, and it will provide the Fed a compass by which to make the adjustments.

Such a price-adjustment rule should be based on an index that can measure price changes for a basket of internationally traded commodities that respond quickly to changes in economic conditions. This index, if properly designed, will give an early warning of inflationary pressures. When the index moves outside a given range, the Fed should announce that it intends to alter its long-term money growth targets accordingly.

Commodity prices, at present, do not indicate inflationary expectations. The shape of the yield curve clearly indicates "excessive tightness." The dollar is a bit weak, not because the Fed is "too loose," but rather because Germany and others are "too tight."

Our economic forecasts for 1989 and beyond are based on an assumption that members of the Fed will come to realize that inflationary pressures are subsiding due in large measure to Fed actions taken early in 1987. We have already seen a decline in the rate of increase in commodity prices from their peak last July. Except for January's numbers, both the Consumer Price Index and the Producer Price Index were signalling steady, if not declining, inflation rates for several months. Rotten inflation news for one month does not establish a trend. Patience in policy responses will allow enough time to establish what the trend is in measured price indexes. Our prediction is that the worst news on inflation has already been heard.

Among the major differences between us and other analysts (including some of those at the Fed) is the importance attached to the concept of full employment. According to their way of thinking, inflationary pressures are greatest when the economy is approaching or is at "full employment." Our point of view is that at any level of unemployment, inflationary pressures arise from excessive infusions of new money. Steady economic growth and gradually declining rates of unemployment indicate that the private economy is performing well.

An unfounded fear of economic growth and falling unemployment appears to be at the heart of short-term Fed policymaking. However, a low-unemployment economy with high utilization of resources is vibrant, enabling workers to obtain well-paying jobs, to spend little time searching for work, to avoid discouragement by finding rewarding work, to gain new skills and to add to productivity.

A growing economy opens up new job opportunities, challenges businesses to be competitive in product and factor markets, adds to profits and incomes, and produces greater incentives for recycling the plant and machinery of a firm or industry that is in decline. In a growing and strong economy there is added resiliency where resources become more adaptable, quickly moving from slumping to healthy endeavors because their value in work today comes to exceed their value in seeking work for tomorrow.

Who's afraid of full employment? Certainly not the unemployed.

RECENT ECONOMIC POLICY DIVISION PAPERS

Testimony on the Outlook for the American Economy in 1989 and 1990, by Dr. Richard W. Rahn, given before the Joint Economic Committee.

David R. Burton, J.D., "Capital Gains Tax Rate Reduction."

Dr. William K. MacReynolds, "Fed Policy in 1989: Avoid the Inverted Yield Curve."

Dr. Donald R. Leavens, "Fiscal Year 1990 Budget," *Special Report*.

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ECONOMIC OUTLOOK

Chamber of Commerce of the United States

May/June 1989

IS THE FED GIVING US A RECESSION?

On May 16, 1989 the Federal Reserve Board's (Fed) Federal Open Market Committee (FOMC) meets to set the course of monetary policy for the next 45 days. FOMC members will decide whether to continue with the Fed's high interest rate policy to slow economic growth and combat what members perceived to be a growing inflation threat, or to set monetary policy off on a new course.

Theirs is not an enviable task. In times like these, the Fed's responsibility for monetary policy places the near-term fate of the economy almost entirely in the hands of the FOMC. All of the members of the FOMC sincerely desire to see maximum sustainable economic growth and falling inflation. And the advice they receive, both from inside and outside the Fed, is conflicting.

A wide segment of the economics profession has been encouraging the Fed to continue, or even to intensify, its efforts to slow the economy to head off accelerating inflation. Those individuals applauding current Fed policies express confidence that the Fed will be able to engineer a "soft landing," which would produce real economic growth for the year around 2.0 to 2.5 percent and bring a declining rate of inflation throughout the last quarter of 1989 and all of 1990.

We have counseled members of the Fed repeatedly that such efforts at fine tuning are likely to bring on an unintended recession and that such efforts are misplaced and ineffective in reducing inflation. We respectfully disagree with the notion that too much economic growth and too many people at work cause inflation. And, we do not concur with the prevailing sentiment that the Fed has the capability to engineer a soft landing. If a soft landing occurs we all should be thankful. It will prove that economists have a patron saint watching over the Fed, an institution burdened with far greater responsibilities than anyone can reasonably place on mere mortals.

The fact remains that today's stringently tight monetary policy is incompatible with even modest economic growth, and the Fed will give us a recession unless this policy is reversed quickly. The most pressing question facing the economy today is: Will the Fed allow the economy to achieve even a modicum of its full growth potential?

A growing number of economic forecasters are projecting a recession sometime late this year or early in 1990. Although time is growing very short, a recession is not yet inevitable. If the Fed would lower interest rates immediately and raise the growth rate of the money aggregates to the midpoint of their established ranges, the economy still could experience real growth this year

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Dr. Lawrence A. Hunter, Deputy Chief Economist
Dr. William K. MacReynolds, Director, Forecasting Section

UNITED STATES ECONOMIC OUTLOOK 1989-1990
Prepared by the U.S. Chamber of Commerce
(Percent change from previous period at seasonally adjusted annual rates unless otherwise indicated by shading.)

	QUARTERS								YEARS		
	Actual	Forecast							Actual	Forecast	
GROSS NATIONAL PRODUCT	89:1	89:2	89:3	89:4	90:1	90:2	90:3	90:4	1988	1989	1990
Real GNP	5.5	0.4	1.7	2.7	3.2	3.3	3.6	3.7	3.9	2.7	3.3
Consumption	1.3	0.3	2.0	2.6	2.9	3.3	3.2	3.6	2.8	2.4	3.0
Residential Investment	-3.6	-1.0	3.9	5.6	7.1	5.3	7.0	6.2	-1.7	2.4	6.5
Nonresidential Investment	9.6	4.7	5.6	6.8	4.7	6.1	4.9	7.2	9.5	5.2	5.9
Equipment	10.2	5.3	7.7	7.0	5.2	6.9	5.3	8.1	13.4	6.0	7.2
Structures	7.9	2.8	-0.6	6.2	2.2	3.3	2.8	5.0	-0.3	3.1	2.9
Exports	10.6	7.6	7.7	6.7	6.6	6.7	6.2	7.0	18.0	9.4	6.9
Real Net Exports (82$B)	-95.6	-89.6	-83.8	-81.2	-80.0	-78.9	-77.3	-75.9	-100.2	-87.6	-78.1
Imports	2.3	3.8	3.0	4.2	4.1	5.0	4.6	4.8	8.7	5.7	4.6
Government Purchases	1.1	1.0	0.6	1.5	-1.7	1.0	1.0	2.4	0.3	2.5	0.4
Final Sales	3.0	1.0	2.7	3.1	3.8	3.6	3.5	4.0	3.7	2.9	3.5
Change in Business Inventories (82$B)	53.8	37.3	31.5	30.6	34.6	30.3	29.0	26.2	42.5	38.3	30.2
Industrial Production	3.1	4.4	5.0	5.7	5.5	5.7	5.8	5.5	5.7	4.6	5.6
New Car Sales (mill.)	9.7	9.6	10.2	10.3	10.7	10.8	10.6	10.8	10.6	10.0	10.7
Domestic Car Sales (mill.)	6.9	6.8	7.2	7.3	7.6	7.6	7.6	7.7	7.5	7.0	7.6
New Housing Starts (mill.)	1.52	1.43	1.52	1.56	1.62	1.66	1.67	1.65	1.49	1.51	1.65
EMPLOYMENT, WAGES AND PRICES											
Civilian Unemployment Rate (%)	5.2	5.3	5.2	5.0	4.8	4.7	4.6	4.5	5.5	5.2	4.7
Compensation	5.7	5.5	5.3	5.3	5.8	5.2	4.9	5.2	4.6	5.4	5.4
Productivity	0.5	1.2	1.4	1.6	1.3	1.4	1.2	1.7	1.5	1.3	1.5
Unit Labor Costs	5.2	4.3	3.9	3.7	4.5	3.8	3.7	3.5	3.1	4.1	3.9
Consumer Price Index	5.3	4.3	3.7	3.4	3.4	3.5	3.3	3.7	4.1	4.2	3.4
Implicit GNP Deflator	3.9	4.6	4.2	3.7	3.5	2.9	3.1	3.2	3.4	4.1	3.1
Prime Interest Rate (%)	11.0	11.5	11.0	10.6	10.4	10.2	10.0	10.0	9.3	10.9	10.2
3-mos. Treasury Bill Rate (%)	8.5	8.8	8.7	8.4	8.2	7.9	7.7	7.5	6.7	8.6	7.8
Corporate Bond Rate (%)	9.7	9.7	9.6	9.6	9.5	9.4	9.3	9.3	9.7	9.6	9.4
Real Personal Disposable Income	7.4	1.0	3.3	3.2	2.2	4.0	3.1	4.6	3.8	4.1	3.6
Changes in Profits from Current Production ($B)[1]	-1.2*	-6.5	7.1	-8.9	4.4	4.5	1.5	8.8	18.0	4.9	9.6

* Projected change from fourth quarter of 1988.

[1] Corporate profits with inventory valuation and capital consumption allowances.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University macro model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains preliminary estimates of the National Income and Product Accounts for the first quarter of 1989. The nation's money supply M(1) is assumed to grow by 4.2 percent in 1989 and 4.1 percent in 1990. The trade weighted exchange value of the dollar rises by 2.0 percent in 1989 and 1.5 percent in 1990.

approaching 3.3 percent. This level of real economic growth is perfectly consistent with falling inflation. In order to achieve this result, the Fed, at the same time that it lowers interest rates, should announce a change in policy to pursue long-term inflation control and then consistently maintain steady monetary growth over the next several years. Unfortunately, we have concluded that the Fed is not likely to follow this optimal monetary course.

However, we do not foresee the current economic slowdown culminating in an actual recession because we anticipate that events will save the Fed from itself. Our forecast predicts falling inflation beginning in the second quarter of 1989, which should provide the Fed a rationale to lower interest rates sufficiently to prevent the economy from slipping into a recession. Core inflation (price increases excluding volatile food and energy sectors) — which rose from 4.4 percent in March, 1988 to 4.7 percent in March, 1989 — will begin to fall late in the second quarter. Moreover, beginning in the third quarter, overall price indexes may begin to show similar declines in their rate of increase from falling energy prices and stabilizing food prices.

If we are correct in our estimate of inflation over the next two quarters, good fortune, rather than precise control the Fed claims for its economic fine tuning capabilities, will allow the economy to avert a recession. We are forecasting falling inflation as the delayed result of Fed policy first implemented in the second quarter of 1987, at which time monetary policy correctly turned restrictive after almost two years of colossal money supply growth. It was this excessive money supply growth in 1985 and 1986, not the robust economic growth of 1987 and 1988, that produced rising rates of inflation late last year and early this year.

If events soon induce the Fed to adopt the correct policies (lower interest rates) for the wrong reason (the mistaken belief that the Fed-engineered economic slowdown dampened inflation), the nation will be spared the tragic consequences of a recession. However, the Fed already has given us unnecessary hardship from lost jobs and income. Moreover, a lucky "soft landing" will ingrain in the institution of the Fed a false sense of accomplishment.

With a taste of what it believes to be success at "combating inflation," the Fed is unlikely to allow interest rates to fall sufficiently this year to give the economy its full head of steam. Hence, our forecast places real growth at 2.7 percent for 1989 rather than the 3.5 percent the economy could have experienced if the Fed had not embarked on its present course a year ago.

If the Fed adopts correct monetary policies based on the mistaken belief that it has accomplished a delicate feat of economic fine tuning, it likely will repeat its recent mistakes after a short respite in an effort to bury inflation once and for all with brute force. The next time around, the Fed and the nation are not likely to be quite as lucky as this time.

Even though we remain sanguine that a recession will be averted during the next four quarters, there remains a distinct possibility that a recession will develop. If we are wrong and inflation does not begin to abate in the second quarter, the Fed, to the cheers of many economists, is likely to redouble its hapless efforts to curtail inflation by destroying economic growth. If this course unfolds, the economy will fail to rebound even modestly in the third and fourth quarters and the Fed will have given us a recession.

If a recession develops, it will be a Fed-autographed replica of several earlier failures by the central bank. The monetary signature is unmistakable. In the fourth quarter of 1988, and again in the first quarter of 1989, real money supply growth was strongly negative. In the last twenty-five years, the

Fed, using restrictive monetary policy, has engineered five previous economic slowdowns, each starting with at least two quarters of negative real money supply growth. During the course of these slowdowns, real GNP growth fell by five to eleven full percentage points. We are now in the sixth such slowdown. In two of the five previous slowdowns the nation was given a full-blown recession. Both recessions already were well underway by the time the third quarter of negative real money growth arrived.

What has proved to be somewhat unique this time around is that the Fed finds itself in a box of its own construction. After revving up the money supply at highly inflationary growth rates during 1985 and 1986 to drive down the value of the dollar, by the first quarter of 1988 the Fed had managed to bring money supply growth back to a rate consistent with sustainable noninflationary economic growth. Just as the Fed recovered from its two-year inflationary binge and was poised to embark on a gradual final assault on inflation, the central bank became fearful that "excessive" economic growth threatened to accelerate inflation. The Fed impatiently began to drive up interest rates with the full intention of creating an economic slowdown.

The Fed has succeeded. The second quarter of 1989 began with no momentum and has shown few signs of picking up strength. The employment report for March was far below consensus opinion, and the unemployment rate rose in one month by 0.3 percentage points to 5.3 percent. The government's latest index of leading indicators fell two months running. The profit outlook for nonfarm businesses turned negative in the first quarter of 1989. Retail sales, when adjusted for price increases, have dropped in 1989. And, in the face of a likely fall in credit demand, the Fed continues to maintain a fed-funds rate in the neighborhood of 10 percent, above where it was in January when credit demand was thought to be higher.

Now the Fed finds itself a hostage of its own inflationary rhetoric. Having spooked markets into interpreting every wiggle in any price index as evidence of accelerating inflation, the Fed discovers it cannot credibly lower interest rates for fear that a decline in interest rates would be interpreted to mean the Fed is abandoning its anti-inflation stance. The consensus of opinion about Fed action as late as the middle of May is that they will stand pat on policy and await anxiously the next news on inflation.

The Fed now may feel it must permit the economy to withstand an economic head-punch, even at the risk of a recessionary knockout, to prove its stamina to markets in the fight against inflation. Unfortunately, it is the worker on the assembly lines and at the construction sites who will be sent reeling and down for the count after being setup by the Fed managers from their ring-side seats at the FOMC.

RECENT ECONOMIC POLICY DIVISION PAPERS

Testimony on the President's Tax Proposals, by Dr. Richard W. Rahn, given before the Committee on Ways and Means.

Testimony on the Presidential Line Item Veto Authority, by Dr. Lawrence A. Hunter, given before the Subcommittee on the Constitution of the U.S. Senate Committee on the Judiciary.

Dr. Donald R. Leavens, "The Battle of the Budget," *Policy Working Papers.*

Dr. William K. MacReynolds, "A Soft Landing or a Hard Fall."

Dr. William K. MacReynolds, "Decision Time at the Fed."

David R. Burton, J.D., "Capital Gains Tax Rate Reduction."

Testimony on the Outlook for the American Economy in 1989 and 1990, by Dr. Richard W. Rahn, given before the Joint Economic Committee.

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ECONOMIC OUTLOOK

Chamber of Commerce of the United States

July/August 1989

HAS THE FED FOUND A NORTH STAR?

Since the end of the recession in late 1982, real GNP growth has fluctuated around a growth path of 3.8 percent, slightly above the post World War II average of 3.3 percent. The last time annual economic growth fell below 2 percent was in the first quarter of 1987. By the end of 1989, annual real GNP growth once again will fall below 2 percent before picking up in 1990.

Thus, it would appear that the economy is headed for a so-called "soft landing" with several quarters of below-trend growth in 1989 that will bring the percent change in real GNP from the same quarter one year ago to 1.9 percent in the fourth quarter of 1989. At the same time, inflation should be falling from annualized rates of about 5 percent during the last few months of 1988 to annualized rates near 4 percent for the rest of 1989.

The Federal Reserve Board (Fed) will, no doubt, take credit for engineering a soft landing by cooling off the growth in the economy and, thereby, bringing the rate of inflation down. Fed analysts, as well as many other analysts, will treat this episode as testimony to the wisdom of timely Fed intervention, and they will extol the virtues of discretionary monetary policy in managing the economy.

However, such plaudits are undeserved. Both the acceleration of inflation and the considerable fluctuations in real GNP growth have been the result of past Fed policy mistakes. Claiming victory for discretionary monetary policy overlooks the fact that excessive use of discretionary authority gave rise to the problem of inflationary pressures in the first place.

Recent Fed research confirms the origins of the recent acceleration of inflation[1]. Fed researchers estimated the long-run price level, called P Star, from a model that featured money supply changes as the prime mover of P Star. In the Fed model, a rising money supply (as indicated by changes in M2, a broad government measure of money supply) in excess of estimated GNP growth leads to a higher long-run price level. During periods when P Star lies above the current price level, the analysis stipulates that inflation will rise. The Fed researchers claim that their model predicts inflation with strong statistical accuracy over the past 35 years and tracks well the historically significant "turning points" in the rate of inflation.

Beginning in 1985 and lasting throughout most of 1986, the Fed stimulated excessive growth in the money supply to bring down the value of the dollar. In 1985, P Star rose above the then current price level signalling an expected pick-up in inflation. The Fed research shows that it may take 24 months or longer for monetary stimulus to affect the price level. Indeed, data on the GNP implicit price deflator and the core inflation rate of the consumer price index (CPI less food and

[1] See *"M2 Per Unit of Potential GNP as an Anchor for the Price Level,"* by Jeffrey J. Hallman, Richard D. Porter and David H. Small; *Staff Study #157*, Board of Governors of the Federal Reserve System, April, 1989.

Economic Outlook, published bimonthly by the Forecasting Section, Chamber of Commerce of the United States of America, provides its readership with the Chamber's official forecast of the U.S. economy. It analyzes the vital issues affecting current economic activity and provides the latest economic trends. Subscription cost is $60.00 per year which includes *Policy Working Papers* published by the Economic Policy Division.

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UNITED STATES ECONOMIC OUTLOOK 1989-1990
Prepared by the U.S. Chamber of Commerce
(Percent change from previous period at seasonally adjusted annual rates unless otherwise indicated by shading.)

	QUARTERS								YEARS	
	Actual	Forecast							Actual	Forecast
	89:1	89:2	89:3	89:4	90:1	90:2	90:3	90:4	1988	1989	1990
GROSS NATIONAL PRODUCT											
Real GNP	4.4	0.4	0.8	2.2	3.8	4.0	4.1	3.4	3.9	2.3	3.0
Consumption	1.3	0.5	0.7	2.5	3.7	3.7	3.2	2.9	2.8	2.0	2.8
Residential Investment	-4.6	-6.8	-4.1	2.6	6.0	7.6	5.1	5.2	-1.7	-0.4	3.3
Nonresidential Investment	7.6	-0.2	0.2	-0.9	1.7	4.4	11.9	3.3	9.5	2.6	2.8
Equipment	9.9	1.1	1.3	-0.2	2.1	4.9	11.3	3.6	13.4	3.7	3.3
Structures	1.3	-3.8	-3.2	-3.2	1.0	2.9	13.2	2.5	-0.3	-0.7	1.3
Exports	15.0	7.8	4.1	2.9	5.0	5.6	3.5	5.0	18.0	9.4	4.7
Real Net Exports (82$B)	-89.5	-77.4	-73.2	-71.8	-68.4	-65.3	-62.8	-58.3	-100.2	-77.1	-63.7
Imports	-0.5	1.3	0.9	1.6	2.3	3.1	1.6	1.7	8.7	4.0	2.0
Government Purchases	1.4	1.2	0.8	1.0	-1.3	1.5	1.3	1.5	0.3	2.4	1.7
Final Sales	3.5	1.0	1.0	2.0	3.5	4.2	4.4	3.2	3.7	2.7	3.0
Change in Business Inventories (82$B)	38.0	29.0	27.0	29.5	33.0	31.5	29.0	31.0	42.5	30.2	31.1
Industrial Production	1.6	1.1	1.2	2.0	4.3	5.7	4.6	3.9	5.7	3.4	3.6
New Car Sales (mill.)	9.7	9.6	10.2	10.3	10.7	10.8	10.6	10.8	10.6	10.0	10.7
Domestic Car Sales (mill.)	6.9	6.6	6.7	6.8	7.6	7.6	7.6	7.7	7.5	6.8	7.6
New Housing Starts (mill.)	1.52	1.34	1.39	1.35	1.46	1.54	1.66	1.65	1.49	1.40	1.58
EMPLOYMENT, WAGES AND PRICES											
Civilian Unemployment Rate (%)	5.2	5.3	5.5	5.7	5.6	5.5	5.4	5.2	5.5	5.4	5.4
Compensation	5.4	5.5	5.3	5.3	5.8	5.2	4.9	5.2	4.6	5.4	5.4
Productivity	-1.1	0.7	0.8	1.6	1.3	1.4	1.2	1.7	1.5	0.9	1.5
Unit Labor Costs	6.6	4.8	4.5	3.7	4.5	3.8	3.7	3.5	3.1	4.5	3.9
Consumer Price Index	6.6	5.3	3.8	3.6	3.5	3.4	3.3	3.2	4.1	4.5	3.5
Implicit GNP Deflator	3.6	4.6	4.2	3.7	3.5	3.2	3.1	2.9	3.4	4.1	3.4
Prime Interest Rate (%)	11.0	11.2	10.5	10.2	9.8	9.7	9.5	9.3	9.3	10.7	9.6
3-mos. Treasury Bill Rate (%)	8.5	8.3	7.8	7.5	7.3	7.1	7.0	6.9	6.7	8.0	7.1
Corporate Bond Rate (%)	9.7	9.3	8.9	8.7	8.6	8.5	8.4	8.4	9.7	9.2	8.5
Real Personal Disposable Income	7.4	0.2	2.0	3.2	2.2	4.0	3.1	4.6	3.8	3.5	2.9
Changes in Profits from Current Production ($B)1	-21.5	-6.5	-4.0	3.2	4.4	4.5	1.5	8.8	18.0	-15.1	9.5

[1] Corporate profits with inventory valuation and capital consumption allowances.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University macro model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains preliminary estimates of the National Income and Product Accounts for the first quarter of 1989. The nation's money supply M(2) is assumed to grow by 3.0 percent in 1989 and 3.2 percent in 1990. The trade weighted exchange value of the dollar rises by 2.0 percent in 1989 and 1.5 percent in 1990.

energy prices) show the acceleration in price increases beginning in 1987. Since the middle of 1988, the actual price level rose very near to P Star. The Fed model suggests that the rise in inflation would be coming to a halt, as it has, by the first few months of 1989.

Thus, over a period of time (about two years) changes in the price level are determined by changes in the money supply. The recent Fed research confirms the findings of Nobel Laureate Milton Friedman in a study conducted some twenty-five years ago. The Fed study is also consistent with other analyses done by Friedman and others, namely, that current dollar GNP tends to grow at a similar rate as the money supply. This means that fluctuations in real GNP (constant dollar GNP) are also related to changes in money supply growth. However, the effect on real GNP comes much sooner — as quickly as six months — than the effect on prices.

This simple model of the economy posits that money supply (using the M2 measure of money) multiplied by how fast money turns over into final product (the income velocity of M2) will equal current dollar or nominal GNP. If velocity of money changes very little (the Fed study assumes a constant velocity of 1.6527, the average velocity of M2 for the past 35 years), fluctuations in money supply will cause nominal GNP to fluctuate. Since nominal GNP is made up of the price level and real GNP, the simple model allows analysts to predict changes in the long-run price level and, hence, short-term variations in real GNP by looking at one variable — money supply.

From this model, there emerges a scenario of how real GNP and inflation change. If the Fed increases money supply growth, nominal GNP growth will rise within three to nine months. The price level, however, is slow to rise. Therefore, real GNP rises before the price level manages to adjust upward. Once the price level begins to accelerate upward, the acceleration in real GNP growth caused by excessive monetary growth begins to dissipate and real GNP growth becomes a smaller portion of nominal GNP growth. Eventually, real GNP growth settles back down to its long-run trend and all of the excessive growth in money supply becomes reflected in a higher price level.

During a portion of the time that the monetary stimulus is causing GNP to rise, the real GNP growth rate and inflation may rise together, which on the surface may appear to be a situation where accelerating inflation is being caused by real GNP growth, when in fact all of the inflation and a significant part of the acceleration in real GNP growth is being caused by excessive money growth. As it has in the past, the Fed is likely to try to reduce inflation by cutting reserve growth severely to raise interest rates and cause a slowdown in economic growth. Stimulative monetary policy thus produces for a time a chain of events that can be misinterpreted and then used as a justification for more misguided discretionary Fed policy.

In the past twenty-five years, the Fed has engineered five episodes of monetary contraction in response to rising rates of inflation which were caused, in the first place, by prolonged periods of excessive money supply growth. During these periods of tight monetary policy, real GNP growth fell anywhere from 5 to a whopping 11 percentage points creating two sizeable recessions and two mini-recessions in the process. However, inflation rates were slow to fall, declining significantly only after prolonged periods of monetary restraint.

Thus, discretionary Fed monetary policy, which has been solely responsible for periods of rising inflation, has created enormous instability in the real economy to correct its past policy mistakes. As a result, the mistakes were compounded. Instead of gradually reducing money supply growth with an eye toward lowering long-run inflation, the Fed caused extensive human misery by fomenting slowdowns that turned into recessions. The simple model shows that money supply stimulation will cause an acceleration of the price level which will eventually come to dominate the rise in nominal GNP. Consequently, real GNP growth will subside to sustainable rates, but not into an unnecessary Fed-induced recession.

The new Fed research finds that a simple model relating money supply to prices is powerful in predicting changes in the price level. Moreover, analysts have long recognized that beyond this model there are few analytical insights into explaining overall economic activity. Many alternative candidate theories have been tested, but do not hold up under scrutiny of data.

Unfortunately, even in the face of their own research, Fed analysts have retained most of the unconfirmed candidate theories to justify discretionary monetary policy.

One of the prominent theories the Fed should discard is the notion that economic growth causes inflation. Throughout most of 1988, Fed analysts warned of inflationary pressures arising from too much economic growth which was straining the capacity to produce. Such "overheating" was evidenced by "tight" labor markets, as witnessed by a falling unemployment rate, and greater utilization of plant capacity. Yet, if there was any "overheating" going on it was due to past Fed-induced increases in the money supply that jolted real GNP growth, but had yet to be reflected in higher rates of inflation. The acceleration in economic growth experienced from the third quarter of 1985, peaking in the last quarter of 1987 and holding up in the first half of 1988, over which the Fed was fretting, was due in large part to the lengthy period of excessive money supply growth in 1985 and 1986.

Fed analysts buttressed their "overheating" scare with the view that the economy was producing above its "potential". By its own reckoning, the Fed staff estimated that actual GNP rose above "potential GNP" in the third quarter of 1987 and has stayed above "potential GNP" since. Today, even in the face of a significant economic slowdown, actual real GNP lies some $69 billion above Fed estimates of "potential GNP".

The problem with the concept of a "potential GNP" is that there are no models to explain it, only hunches. Over time, these hunches change. This is true at the Fed. In a 1982 internal study, a Fed researcher found that economic growth "potential" from that time on would not likely fall below a 3 percent annual rate. However, in estimating P Star, Fed researchers used a lower estimate of "potential GNP". The new Fed study places GNP growth "potential" at 2.5 percent not only for the present period, *but dating back to 1981.*

It is incumbent on the members of the Fed to discern good theory from useless hunches. Well-documented theory suggests that accelerating inflation comes from one source — excessive monetary growth. And stimulating money supply growth will cause GNP to fluctuate. When real GNP rises without a monetary stimulus, it comes from improvements in productivity and profitability which serve to reduce, not raise, inflationary pressures.

The Fed should not prevent real GNP from rising except when it has mistakenly stoked the fires of inflation. And even then, the Fed must be careful to bring inflationary pressures down slowly so as not to interfere with the forces in the economy that promote jobs, productivity, profits and human welfare. Slamming on the monetary brakes, as the Fed has done during the past nine months, raises fears of recession in the private economy. Businesses are then induced to forgo expansion activity to await signs of a resumption in economic growth. Consequently, the resulting inflation from the original monetary stimulus is exaggerated and prolonged.

The current slowdown is the result of two Fed mistakes, over-stimulation of money supply followed by severe restrictions on money supply growth. The logical next step is for the Fed to ease its grip on credit to allow interest rates to fall. Unfortunately, the Fed will likely overreact as it has in the past and create a new inflationary period.

If members of the Fed would focus on the only economic parameter it can hope to control — long-run inflation — instead of basing policy on holding real GNP hostage to high interest rates, price stability will become a reachable goal. Until then, the Fed will continually move the economy off course never reaching its final destination, and like a toy airplane, the economy will be left much in need of repair after each unscheduled landing.

RECENT ECONOMIC POLICY DIVISION PAPERS

Dr. Richard W. Rahn, "Eastern Europe Needs a Parallel Currency."

Dr. Donald Leavens, "Tight Fed Policy . . . Where Will It Lead?,"

Dr. William K. MacReynolds, "What's Happening With Inflation."

Dr. William K. MacReynolds, "How Fast Is Economic Growth Falling?"

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ECONOMIC OUTLOOK

Chamber of Commerce of the United States

September/October 1989

INFLATION IS FALLING,

INFLATION IS FALLING

In our May/June *Outlook*, we predicted that inflation would begin to decline late in the second quarter, and it has. From June through August, the overall Consumer Price Index (CPI) rose at an annual rate of 1.6 percent, the lowest three-month rate since 1986. Core inflation, the CPI less volatile food and energy prices, rose at an annual rate of 3.1 percent over the same time period. This is the lowest three-month increase since 1983 and represents a significant decline from a 4.6 percent increase in core inflation over the last twelve months.

Our forecast indicates that inflation will be below the 4 percent rate for the remainder of 1989 and will fall to 3 percent by the end of 1990. Consequently, interest rates, especially short-term rates, will decline and economic growth will remain in what we consider a moderate range of close to 3 percent. By the first quarter of 1990, the economic slowdown, which began in the first quarter of 1988, will end. An economic "soft landing" — or more accurately "low altitude flying" (where the economy grows at "below trend" rates of 1.5 to 2 percent for the next four quarters to bring yearly growth into the 2 to 2.5 percent "trend" range) — will not occur. Whenever the Federal Reserve Board (Fed) has kept growth below 2 percent for a year's time, the economy has suffered a recession in the following year. Thus, a "soft landing" is inconsistent with the historical record and if the Fed persists in pursuing this goal, it will push the economy into a full blown recession without achieving any further reduction in inflation than we predict will occur with higher growth. We believe the Fed will recognize this fact, forsake its ill-advised policy and allow the economy to grow.

A reduction in the rate of inflation has been a long time coming. Since the Fed first became concerned about a buildup in inflationary pressures way back at the beginning of 1987, it has taken two-and-a-half years of monetary restraint to finally achieve the inflation reduction. The inflationary pressures which became a source of concern in 1987 were created by the Fed itself, when in 1985 and 1986 it pushed up money supply growth to double-digit rates. The Fed's shift to more conservative rates of monetary expansion, a policy step that was initiated in early 1987, has finally paid off.

We have always believed that monetary restraint would contain inflation and eventually reduce it. The notion that proper monetary restraint leads to reduced inflation is based upon twenty-five years of research, which the Fed now has verified with research of its own. The central idea that emerges from studies on inflation is that inflation is a monetary phenomenon. However, from late 1987 to the present, the Fed has made increasingly strident claims that inflationary pressures come from sources other than past monetary expansion. The Fed has repeatedly warned the public of the threat of accelerating inflation from such bogus sources as too much economic growth as the economy approached high levels of resource utilization.

As strictly a monetary phenomenon, inflation is caused by mistaken monetary policy. Inflation results when there is too much money chasing too few goods. Thus, inflation will increase if the Fed creates too much money and inflation will fall if money supply growth is curtailed sufficiently.

Typically, it takes as long as two years for changes in money supply growth to impact the rate of inflation. During an excessive monetary expansion, nominal GNP growth (demand) tends to rise within about six months after the infusion of new money. Before the general

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UNITED STATES ECONOMIC OUTLOOK 1989-1990
Prepared by the U.S. Chamber of Commerce
(Percent change from previous period at seasonally adjusted annual rates unless otherwise indicated by shading.)

	QUARTERS							YEARS		
	Actual	Forecast						Actual	Forecast	
GROSS NATIONAL PRODUCT	89:2	89:3	89:4	90:1	90:2	90:3	90:4	1988	1989	1990
Real GNP	2.5	2.4	2.3	2.9	3.4	2.9	3.0	4.4	3.0	2.8
Consumption	1.9	2.7	2.0	2.7	3.1	2.7	2.6	3.4	2.5	2.6
Residential Investment	-12.3	-3.6	2.4	5.1	3.6	6.0	1.8	-0.4	-2.1	2.0
Nonresidential Investment	8.6	4.6	4.8	3.8	4.4	7.2	8.7	8.4	3.8	5.1
Equipment	14.8	6.2	4.6	5.1	4.3	8.4	10.6	11.5	6.0	6.4
Structures	-9.5	-1.4	0.7	-0.7	4.8	3.0	2.0	-0.1	-2.7	0.5
Exports	13.1	6.7	6.6	8.3	6.7	5.8	5.6	17.6	11.0	7.3
Real Net Exports (82$B)	-51.2	-50.5	-47.4	-45.6	-41.9	-40.8	-39.9	-74.9	-51.0	-42.0
Imports	9.3	4.8	4.2	6.6	4.0	4.8	4.8	6.8	5.8	5.3
Government Purchases	5.4	-1.7	-0.5	1.5	0.6	-0.9	0.6	0.4	2.8	0.5
Final Sales	3.1	2.0	2.1	2.9	3.2	2.8	3.0	4.3	3.1	2.7
Change in Business Inventories (82$B)	19.1	20.5	22.3	22.3	24.9	25.7	25.8	27.9	21.5	24.7
Industrial Production	2.0	2.3	2.1	2.3	4.6	5.1	4.5	5.7	3.4	3.0
New Car Sales (mill.)	10.3	10.6	10.5	10.7	10.9	11.0	11.0	10.6	10.3	10.9
Domestic Car Sales (mill.)	7.3	7.6	7.5	7.7	7.9	8.0	8.1	7.5	7.3	7.9
New Housing Starts (mill.)	1.36	1.40	1.50	1.58	1.62	1.64	1.66	1.49	1.44	1.62
EMPLOYMENT, WAGES AND PRICES										
Civilian Unemployment Rate (%)	5.3	5.3	5.4	5.5	5.5	5.4	5.3	5.5	5.3	5.4
Compensation	6.6	5.2	4.8	4.6	4.4	4.3	4.2	4.9	5.6	4.8
Productivity	0.9	0.8	0.7	1.8	2.2	2.1	1.9	1.8	1.1	1.6
Unit Labor Costs	5.7	4.4	4.1	2.8	2.2	2.2	2.3	3.1	4.5	3.2
Consumer Price Index	5.7	3.1	3.5	3.4	3.3	3.1	3.0	4.1	4.7	3.5
Implicit GNP Deflator	4.6	3.8	3.7	3.4	3.1	3.0	2.9	3.3	4.1	3.6
Prime Interest Rate (%)	11.3	10.4	9.8	9.3	9.1	8.8	8.7	9.3	10.7	9.0
3-mos. Treasury Bill Rate (%)	8.4	7.8	7.3	6.9	6.6	6.4	6.4	6.7	8.0	6.6
Corporate Bond Rate (%)	9.5	8.9	8.6	8.4	8.2	8.0	7.9	9.7	9.2	8.1
Real Personal Disposable Income	0.8	1.0	1.2	1.9	2.3	4.7	5.0	4.4	3.5	2.2
Changes in Profits from Current Production ($B)[1]	-8.5	-2.0	1.8	3.6	9.1	7.0	6.1	29.9	-18.6	13.0

[1] Corporate profits with inventory valuation and capital consumption allowances.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University macro model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains final estimates of the National Income and Product Accounts for the second quarter of 1989. The nation's money supply M(2) is assumed to grow by 3.5 percent in 1989 and 4.5 percent in 1990. The trade weighted exchange value of the dollar rises by 2.0 percent in 1989 and 1.0 percent in 1990.

level of prices rise, the supply of goods and services — real GNP — will tend to rise in response to the increased demand. Thus, an inflationary expansion of the money supply leads to a rise in economic growth followed by rising inflation. As inflation picks up, wages and other costs also rise. Confusion about the source of inflation arises when analysts ascribe higher rates of inflation to rising economic growth, higher wages and rises in other costs. This mistaken conclusion is understandable, but dangerous if policy is based upon trying to correct past mistakes by engaging in the impossible job of fine-tuning the economy.

To stop an inflationary expansion in demand, money supply growth must be brought down below the growth in nominal GNP (demand) for a prolonged period of time. Again, within six months of a sufficient reduction in money supply growth, demand growth will begin to slow. Businesses will find it difficult to pass rising costs along to consumers, output growth will be cut back and, eventually, price and cost increases will subside. The only way that rising costs will cause inflation to accelerate is if the Fed accommodates cost increases by augmenting money supply growth.

As we mentioned above, it has taken a long time for conservative monetary growth to lower the rate of inflation. Up through the second quarter of 1988, demand for goods and services, as measured by nominal GNP, was increasing. No doubt this rise was unsettling to members of the Fed. In the four quarters that followed, however, nominal GNP growth has slowed to 7.5 percent and, most likely, will soon begin to rise between 6 and 7 percent before falling even further. Table 1 illustrates the decline in monetary expansion over the past several years.

Table 1

MONEY AGGREGATE GROWTH
1986 TO PRESENT
(Compound annual rates from fourth quarter amounts except where indicated)

	1984-86	1985-87	1986-88	1/87-7/89	12/88-6/89
M1	13.8%	10.9%	5.4%	2.5%	-5.1%
M2	9.1	6.7	4.7	4.0	1.2
Monetary Base	9.1	8.6	7.2	5.9	3.0
Reserves	13.8	10.0	3.9	-0.2	-5.1
Currency	7.4	8.0	8.4	6.5	5.3

Clearly, one key result of Fed policy in the last two-and-a-half years (1/87 to 7/89) has been to slow the growth in monetary aggregates. Due to its control over reserves, the Fed has the greatest impact on reservable accounts which make up the largest portion of M1. However, instead of the usual two-year lag between reduced money growth and falling inflation, the lag has been two-and-a-half years. One important reason for the delay is due to the Fed's high interest rate policy of 1988 and early 1989. High interest rates acted to slow economic growth (real GNP growth). Thus, price increases became a larger portion of nominal GNP growth in 1988 and early 1989 than otherwise would have been the case.

Monetary restraint must be gradual to bring inflation down. If the slowdown in money growth is severe enough, as it threatened to become from late 1988 through the middle of 1989, and demand growth subsequently falls dramatically and abruptly, many businesses may fail before they can make sufficient cost, financing and production adjustments. As a result, the entire output of failed businesses will be lost.

This may lead to a significant slowdown or a recession and the opportunity for any sizeable reduction in inflation will be lost. Since goods production actually falls in a recession, a recession does not alter the inflation environment — there is still too much money chasing too few goods. Moreover, once the Fed recognizes a recession is underway, it will rapidly increase money supply growth, as it always has, to try to bring the economy out of its tailspin. With such added monetary stimulus, nominal GNP does not fall and inflationary pressures will be retained in the economy.

During the first six months of 1989, initial government reports indicated that a sizeable economic slowdown was in store. Concern over increased risks of a recession were based upon extremely low growth in monetary aggregates. As Table 1 indicates, from December 1988 to June 1989, M1 and bank reserves actually declined. If it weren't for growth in currency held by the public and new additions to money market funds and small time deposits, all aggregates would have fallen. Belatedly in June, the Fed allowed interest rates to fall and since then there has been an increase in growth of all the aggregates with a surge in M2 growth.

Yet when the early 1989 government reports were later revised, the surprise was that all the numbers went in the direction of higher-than-anticipated economic growth. Through the second quarter of 1989, real GNP (output) stood 3.0 percent higher than the second quarter real GNP in 1988, well above the "below trend" growth many analysts, including those at the Fed, believe is necessary to bring inflation down.

But inflation has come down nonetheless, which flies in the face of the Fed's notion that the economy of its own accord can grow too fast, or in the technocratic jargon "exceed its growth potential." Such a notion is nonsense. The U.S. market economy has a natural, strong tendency to grow. "Excessive growth" implies that the economy is prone to runaway inflation and lacks the discipline of market adjustment, making it

fragile after several years of economic expansion and vulnerable to unchecked price increases. A market economy works in the opposite manner: Markets continually correct for shortages by changing relative prices. The only way the natural operation of a free market economy can exceed its "growth potential" is if the central bank artificially inflates growth by allowing the money supply to grow too fast; and even then the effects on real output are temporary and will dissipate as the excessive money growth gradually translates into a general rise in prices.

Fed estimates of potential GNP growth have become more conservative. By late 1987, Fed researchers had revised their 1982 study results, which placed a floor of 3 percent on potential GNP growth. The new estimates were revised downward, placing a 2.5 percent ceiling rate on non-inflationary growth potential. Utilizing what we consider a discredited Keynesian construct, the Fed argued that excessive economic growth in the present, not past excessive monetary growth, would cause inflation to accelerate. Consequently, the Fed launched in 1988 an ill-founded policy to rid the economy of inflationary pressures by raising interest rates to slow down economic growth. It was the Fed's apparent disregard of the ultimate cause of inflation, excessive money supply growth, and its use of improper analysis that caused us to question the Fed's method of combating inflation.

It is time to let go of a low estimate of economic growth potential because falling inflation belies it. From the beginning of 1984, core inflation had fluctuated very little, from between 4 and 5 percent, averaging 4.4 percent. This fairly long period of stable inflation suggested to us that growth potential had actually increased, and the amount of growth the economy was experiencing in 1988 was not excessive.

We believe that economic growth can and will rise above 3 percent in the future, even in the face of continued monetary restraint. Since early 1987, real GNP moved above the Fed's low estimates of GNP potential. The gap between the Fed's estimate of potential GNP and actual real GNP has been rapidly increasing, at a time when money supply growth and inflationary pressures were falling. The Fed's estimate of potential GNP is thus, demonstrably, too low. Fed policy to reduce growth has resulted in a needless loss of output and jobs. It may also serve to reduce future growth potential by discouraging investment with high interest rates.

The key to solving the long-term inflation problem is to find the right amount of money supply growth. Presently, the best approach the Fed can take is to set growth in the monetary base, M1, and M2 somewhat below nominal GNP growth. As a result, nominal GNP growth will fall bringing inflation down.

Continuation of the decline in nominal GNP growth is the key to ridding the economy of inflation. However, inflation cannot be brought down all at once. During most of 1988 and in the first five months of 1989, the Fed lost patience. It had grown tired of waiting for inflation to come down and, perhaps, reached too far to come up with justifications to, in effect, "Whip Inflation Now." As a result, the Fed abandoned a proper course of monetary restraint by substituting a form of fiscal policy restraint on demand thereby threatening to bring the economy close to a recession.

The signs of receding inflationary pressures have been around for many months. The dollar has been rising. Commodity prices have actually fallen. The yield curve has been inverted since the beginning of 1989. There have been a growing number of reports that businesses could not get price rises to stick. The price of gold has fallen.

The August CPI report confirms that inflation is really falling. The economy is poised to experience a period of falling inflation and continued moderate economic growth if the Fed can avoid further fiscal-like forays which do nothing to alter the present course of inflation. The Fed can get on track if it would maintain growth between 4 and 5 percent in M1 and M2 and avoid the mistakes of trying to fine-tune the economy. Our forecast reflects our optimism that the Fed will do the right thing.

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